The Tennessee Advisory Commission on Intergovernmental Relations

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MEMORANDUM

TO: TACIR Commission Members

FROM: Harry A. Green Harry
Executive Director

DATE: June 12, 2008

SUBJECT: State and Local Government Fiscal Health

1. Governments across the nation are having a difficult time balancing their budgets in the face of revenues declining as a result of the ongoing economic downturn. As discussed in Tab 7 of this docket book, these difficulties are further complicated by increased service costs tied to the rising cost of petroleum and other energy sources.

2. This tab (Attachment 1) includes extracts from five reports that provide a national perspective on the effects of the economy on state and local governments and possible mitigation strategies:

   - McNichol, Elizabeth C. and Iris J. Lav. "27 States Face Total Budget Shortfall of at least $47 Billion in 2009; 4 Others Expect Budget Problems." Center on Budget and Policy Priorities. Revised May 21, 2008.

   - Boyd, Donald J. "What Will Happen to State Government Finances in a Recession?" Rockefeller Institute Fiscal Report. January 30. 2008.

   - Dadayan, Lucy and Robert B. Ward. “State Tax Revenue Weakens Still Further, While Costs Rise Sharply.” Tax Analysts: State Tax Notes, Vol. 48, Number 5. May 5, 2008.

   - Baker, Dean. "Recession Looms for the U.S. Economy in 2007." Center for Economic and Policy Research. November 2006.

- Hutchinson, Paul. "Management Insights: It's a Recession: Attack the Status Quo." Governing.com. January 30, 2008.

3. An analysis of historical trends has shown that Tennessee has had to increase its sales tax rate about every eight or nine years due to the tax's inelasticity, its inability to grow as a revenue source at the same rate as the economy or service demands. At the June 2008 meeting, TACIR staff will present an update on the current status of the sales tax in Tennessee.

4. Tennessee's local governments are particularly vulnerable to the effects of the economic downturn. As discussed in the July 2007 TACIR brief, *Local Taxing Authority* (*Fiscal Flexibility Series, Volume 4*), local governments in Tennessee have few options for raising new revenue:

   > *Local governments in Tennessee have few taxing options available to them, and they rely primarily on the property tax and the local option sales tax. The property tax is the only unrestricted revenue source for local governments in Tennessee. The local option sales tax is capped at 2.75%, applies only to the first $1,600 of the price of an item, is subject to state sales tax exemptions, and is subject to the requirement that any increases must pass a voter referendum. Additional, though less significant, revenue sources for local governments include the wheel tax, the local portion of the state gross receipts tax, the hotel/motel tax, and a local gasoline tax.*

5. TACIR staff will present an analysis of the potential prolonged effects of the economic situation on Tennessee and its local governments at the June 2008 Commission meeting.

6. In Attachment 2 you will find: a Department of Finance and Administration media release on April 2008 revenues (2a), April 2008 collections data from the Department of Finance and Administration (2b), and an excerpt from the National Conference of State Legislatures State Budget Updated: April 2008 (2c).

National Perspective

McNichol, Elizabeth C. and Iris J. Lav. "27 States Face Total Budget Shortfall of at least $47 Billion in 2009; 4 Others Expect Budget Problems." Center on Budget and Policy Priorities. Revised May 21, 2008.

At least 27 states plus the District of Columbia faced or are facing an estimated $47 billion in combined shortfalls in their fiscal year (FY) 2009 budgets. Two more states also face shortfalls for FY 2009, but the size of their shortfalls has not been estimated, bringing the total number to 29 states. Two other states expect problems in FY 2010, although some of those gaps may occur earlier than expected.

The 27 states that have or will have revenue short falls in FY 2009 are Alabama, Arkansas, Arizona, California, Delaware, Florida, Georgia, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Hampshire, New Jersey, New York, Ohio, Oklahoma, Rhode Island, South Carolina, **Tennessee**, Vermont, Virginia, Wisconsin, and the District of Columbia. Connecticut and Mississippi also face or faced budget shortfalls but the size of these deficits is not available. Missouri and Texas expect shortfalls in FY 2010. A total of 31 states are facing budget gaps. The remaining 19 states did not foresee FY 2009 budget gaps at the time of the survey, either because their budgets remain strong or because they have not yet prepared updated revenue and spending projections.

This article reports that mineral-rich states (New Mexico, Alaska and Montana) are seeing revenue growth as a result of high oil prices. This does not mean local governments in those states will not have fiscal stress, however. The housing bubble has still affected these states which can be felt at the local level.

The failing housing market has reduced state sales tax revenue from related sales (furniture, appliances, etc.) and weakening consumption of other products has also reduced sales tax revenue. Property tax collections have also been affected and local governments will look to states to help with the squeeze on local and education budgets. If employment trends continue to deteriorate, income tax revenues will also suffer, which in turn, puts further downward pressure on sales tax revenue.

In response, states can:

- draw down available reserves,
- cut expenditures, or
- raise taxes.

Spending cuts and tax increases can further slow a state’s economy during a downturn and contribute to the further slowing of the national economy. The authors highlight experiences from the last recession as instructive for what actions states may take.

- *"Cuts in services like health and education.* In the last recession, some 34 states cut eligibility for public health programs, causing well over 1 million people to lose health coverage, and at least 23 states cut eligibility for child care subsidies or otherwise limited access to child care. In addition, 34 states cut real per-pupil aid to school districts for K-12 education between 2002 and 2004, resulting in higher fees for textbooks and courses, shorter school days, fewer personnel, and reduced transportation.
- *"Tax increases.* Tax increases may be needed to prevent the types of service cuts described above. However, the taxes states often raise during economic downturns are regressive — that is, they fall most heavily on lower-income residents.
- *"Cuts in local services or increases in local taxes.* While the property tax is usually the most stable revenue source during an economic downturn, that is not the case now. If property tax revenues decline because of the bursting of the housing bubble, localities and schools will either have to get more aid from the state — a difficult proposition when states themselves are running deficits — or reduce expenditures on schools, public safety, and other services."

Many states have not fully recovered from the fiscal crisis in the early part of the decade which had led to them restraining spending and accumulating rainy day funds. As a result, those states with rainy day funds are slightly better off now than in previous recessions.

Ultimately, the report argues federal assistance can help states, which will in turn help the national economy. "The federal government should consider aiding states earlier, rather than waiting until the downturn is nearly over."

This article is available at http://www.cbpp.org/1-15-08sfp.pdf.

Boyd, Donald J. with the assistance of Lucy Dadayan. "What Will Happen to State Government Finances in a Recession?" Rockefeller Institute Fiscal Report. January 30. 2008.
(direct excerpt, pp. 25-6)

The economy has weakened and is at substantial risk of recession, if we are not already in one now. Recessions vary enormously in their depth and duration, and in their regional impact. Although economic volatility has been declining, the reasons for the decline are not fully sorted out by economists and future recessions well could be as severe as those earlier in the postwar period. Furthermore, even mild recessions can have drastic impacts on state tax revenue. The 2001 recession was the mildest postwar recession and yet it caused real state government tax revenue to decline more steeply than it had at any time since 1959.

Each recession has a different effect on different taxes, and affects the regions of the country differently. It is difficult to predict in advance how different regions and taxes will be affected. At present, the regions of the country most affected by the mortgage crisis appear likely to be at greatest risk — in particular, California, Florida, Michigan, and Ohio, and other parts of the Southwest, Southeast, and Great Lakes regions.

One of the reasons the 2001 recession had such a sharp impact on state tax revenue is that revenue had increased rapidly prior to the recession in an unsustainable way, in part because of a soaring stock market and large increases in capital gains. While capital gains have not yet increased to their pre-2001 level as a share of income, they are quite close, meaning that they are once again susceptible to a sharp drop if conditions become right. While it is hard to imagine stock markets selling off again as much as they did in the 2000 through 2002, the broad market is down about 7 percent at this writing and revenue related to investments is at substantial risk.

States' expenditure patterns generally tend to be pro-cyclical. In boom times, states tend to enact larger-than-average increases in spending on education, transportation, and other services and programs. During economic downturns, states may be forced to spend more on social-welfare programs, but overall spending increases are likely to be constrained by limited revenues. In 2008, a short, mild recession might result in only limited fiscal response by states, with little import for the national economy. A more pronounced, deeper downturn, on the other hand, could force states into staff reductions and other spending cuts that could add to the nation's economic woes.

What can states do to prepare for the heightened risk? The first set of answers relates to decisions made during times of expansion. States should maintain and increase reserve funds, where possible. Studies have shown that reserve funds generally are not anywhere large enough to fully dampen the effects of a recession, but that they do tend to soften some of the policy responses otherwise needed. States that rely on a balanced portfolio of taxes rather than depending primarily on a single tax may enjoy more consistent revenues than others. And finally, of course, states can prepare budgets conservatively, even when revenues are strong, and avoid long-term spending commitments based on revenue sources that appear unsustainable.

As for budgets adopted in 2008, states should inform their revenue projections with a healthy consideration of potential risks. When many economists say their own predictions are weighted to the downside, states may wish to err on the low side in estimating projected revenues, and to shape decisions on the expenditure side of the budget accordingly.

This article is available at
http://www.rockinst.org/WorkArea/showcontent.aspx?id=13894.

Dadayan, Lucy and Robert B. Ward. "State Tax Revenue Weakens Still Further, While Costs Rise Sharply." Tax Analysts: State Tax Notes, Vol. 48, Number 5. May 4, 2008.
(direct excerpts, pp. 397-399)

Historically, costs for state and local governments have moved roughly in tandem with costs in the overall economy and those facing the federal government. Over the past three years, however, inflation for state and local expenditures — as measured by the BEA's price index for government expenditures has diverged sharply from other measures.

The BEA's price index for state and local government expenditures rose at annual rates of 1.5 percent to 4 percent for most of the 1990s, as did the price indexes for federal government expenditures and for the overall economy. Inflation for both federal expenditures, and for those at the state and local level, rose to more than 5 percent in late 2004 and early 2005, while the BEA's broad measure of inflation throughout the economy remained below 3.5 percent. Quarterly measures of cost inflation for states and localities rose at an even faster rate, above 6 percent, through 2006 — far outpacing cost increases for federal expenditures and for the economy as a whole.

Other things being equal, high rates of inflation for state and local expenditures imply a reduced level of services for a given level of taxpayer resources.

States and localities are also experiencing major increases in costs for health and pension benefits for both current and retired employees. From 2000 to 2006, BEA price indexes show above-average inflation for state and local expenditures in transportation, housing and community services, recreation and culture, and public schools.

States are experiencing a classic nutcracker effect: Costs are rising sharply just as revenue falters. The result may be a squeeze on states' ability to fund services.

National economic trends are holding state revenue growth to the lowest levels in nearly five years. All three major state tax sources showed slow growth in the fourth quarter of 2007, compared with the previous three quarters of 2007. Both personal income tax and sales tax continued to lag, with the slowest growth rates since the second quarter of 2003. Meanwhile, states' corporate income taxes showed their weakest performance since the first quarter of 2002.

The national economic slowdown — or recession — is likely to depress state revenue, at least during the first quarter of 2008. Actions by the Federal Reserve, the fiscal stimulus plan enacted by President Bush and Congress, and other economic forces will all produce results that are difficult to project. One apparently safe prediction: There's a very difficult year ahead for state budget makers.

Baker, Dean. "Recession Looms for the U.S. Economy in 2007." Center for Economic and Policy Research. November 2006.

This article was written in late 2006 projecting economic decline for the coming year (2007) and beyond. Dean writes,

> Government spending is likely to make somewhat more of a contribution to GDP growth in 2007, primarily due to the relatively rapid growth of state and local spending. State and local spending had grown very slowly from 2002 to 2005 as many states were in a weak financial situation following the recession. However, state and local finances are considerably stronger in most areas and there is backlog of unmet demands. While tax collections may slow over the course of 2007, appropriations will have been made when the budget situation was relatively strong. State and local spending will grow by 3.0 percent in 2007 (14).
>
> The ability of the economy to recover from the 2007 recession will depend both on how quickly the imbalances are corrected (the housing bubble and the over-valued dollar) and the direction of the policy response. The Federal Reserve Board will have to choose whether to fight the risk of inflation associated with a declining dollar (which is essential for correcting the trade imbalance) or whether to provide stimulus to counterattack the slump brought on by the collapse of the housing bubble. Since there may be no consensus for either path, it is very possible that it will end up in an intermediate position where it lowers interest rates modestly, but does not act to aggressively counteract the slump.
>
> Fiscal policy could be subject to a similar paralysis. It would be reasonable for Congress to enact a stimulus package including tax cuts and/or spending measures to counteract the slump; however, concern over the size of the deficit could prevent effective action. If political factors prevent effective monetary and fiscal measures, then a slump caused by the collapse of the housing bubble could be prolonged considerably (19).

Hutchinson, Paul. "Management Insights: It's a Recession: Attack the Status Quo." Governing.com. January 30, 2008.

The author asserts the country *is* in a recession and it will be harder on state and local governments than the last recession (2001) because in 2000, state reserves were ten percent of budgets. Now, reserves are at seven percent of state budgets and falling, not to mention the rising costs of everything and increased demand for service, especially health care.

Hutchinson suggests that the period before or during recessions, state and local governments usually ignore the truth or continue spending at the expense of public employees or through deferrals. He asserts there is a third choice, to change government meaningfully and eliminate costs that do not actually create value for citizens.

In particular, Hutchinson points out reducing the following:

- *Health* “20-30% of costs in health care don’t make us healthier, and may actually make us worse.”
- *Mistrust* “Up to a third of government’s overall costs pay to enforce rules, regulations and red tape.”
- *Education* “The real cost to educate our kids has skyrocketed, and yet there has been little measurable impact on learning.”
- *Monopoly* “Competitive contracting, even when government wins the competition, results in costs 15-30 percent lower than continuing government’s monopoly.”

Hutchinson believes real leaders balance budgets by challenging the status quo and winning the competition for public support.

This article is available at http://www.psg.us.resources/newsitsarecession.html

MEDIA RELEASE

STATE OF TENNESSEE
DEPARTMENT OF FINANCE & ADMINISTRATION

FOR IMMEDIATE RELEASE
MONDAY, MAY 12, 2008

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APRIL REVENUES

NASHVILLE - Tennessee's sales tax collections dropped to a record low in April with a negative growth rate. Finance and Administration Commissioner Dave Goetz reported today that overall April revenues were $1.39 billion or $88.9 million less than the state budgeted.

"Almost two dozen other states are experiencing similar revenue conditions; we expected a slowdown in growth, but nothing this dramatic," Goetz said. "We are committed to keeping our spending in line with revenues, while balancing the budget without raising taxes or raiding the Rainy Day Fund to cover the shortfall."

On an accrual basis, April is the ninth month in the 2007-2008 fiscal year.

The general fund was under collected by $92.8 million, and the four other funds were over collected by $3.9 million.

Sales tax collections were $49.8 million less than the estimate for April. The April growth rate was negative 4.08%. For nine months revenues are under collected by $167.5 million. The year-to-date growth rate for nine months was 1.11%.

Franchise and excise taxes combined were $50.4 million below the budgeted estimate of $428.9 million. For nine months revenues are under collected by $136.8 million.

Hall Income tax collections for April were $33.3 million more than the estimate. For nine months collections are $28.6 million more than the estimate. The growth rate for the nine month period was 17.2%.

Inheritance and estate tax collections were $1.7 million above the April estimate. For nine months collections are $6.6 million above the budgeted estimate.

Gasoline and motor fuel collections for April increased by 2.58%. For nine months revenues are over collected by $8.3 million.

Tobacco tax collections were $9.2 million under the budgeted estimate of $33.1 million. For nine months revenues are under collected in the amount of $61.2 million.

Year-to-date collections for nine months were $356.9 million less than the budgeted estimate. The general fund was under collected by $368.6 million and the four other funds were over collected by $11.7 million.

The budgeted revenue estimates are based on the State Funding Board's consensus recommendation adopted by the first session of the 105th General Assembly in June of 2007.

The revised estimates for this fiscal year as presented in the 2008-2009 Budget Document assumes an under collection in total taxes in the amount of $165.4 million. By tax source the assumed under collections are: Sales tax $62.8 million; F&E taxes $54.8 million; tobacco taxes $30.0 million; privilege taxes $27.6 million; and, a net over collection of$9.8 million from all other tax sources. The General Fund under collection is projected to be $180.0 million.

The State Funding Board met on April 29 and May 1, 2008 and adopted revised revenue growth ranges for the current fiscal year ranging from 0.25% to 1.00% for total taxes and -0.50% to 0.25% in general fund taxes.

Theses ranges recognize a revenue shortfall in total taxes from the original budgeted estimates in the amount of $562.8 million at the low end to $479.9 million at the high end. The ranges for the general fund recognize a shortfall of $564.0 million at the low end to $494.5 million at the high end.

Attachment 2b

REVENUE COLLECTIONS
APRIL, 2008, AND 9 MONTHS YEAR-TO-DATE

April Collections:

	Budgeted Accrual Estimate	Actual	Difference
General Fund	$1,248,193,000	$1,155,371,000	($92,822,000)
Highway Fund	68,178,000	64,059,000	(4,119,000)
Sinking Fund	26,967,000	26,593,000	(374,000)
City & County Fund	134,064,000	142,529,000	8,465,000
Earmarked Fund	3,398,000	3,388,000	(10,000)
Total	**$1,480,800,000**	**$1,391,940,000**	**($88,860,000)**

Year-To-Date Collections:

	Budgeted Accrual Estimate	Actual	Difference
General Fund	$7,250,964,000	$6,882,346,000	($368,618,000)
Highway Fund	523,700,000	525,051,000	1,351,000
Sinking Fund	240,114,000	238,689,000	(1,425,000)
City & County Fund	638,581,000	650,124,000	11,543,000
Earmarked Fund	25,827,000	26,065,000	238,000
Total	**$8,679,186,000**	**$8,322,275,000**	**($356,911,000)**

Table 1
Tennessee Department of Revenue
Comparative Statement of Collected Revenues

Class of Tax	April 2007	2008	Change	Percent
Franchise & Excise	$402,635,000	$378,522,000	-$24,113,000	-5.99%
Income	201,628,000	240,523,000	38,895,000	19.29%
Inheritance & Estate	16,429,000	17,639,000	1,210,000	7.37%
Gasoline	47,127,000	49,382,000	2,255,000	4.78%
Petroleum Special	5,266,000	5,298,000	32,000	0.61%
Tobacco	16,834,000	23,862,000	7,028,000	41.75%
Beer	1,701,000	1,540,000	-161,000	-9.47%
Motor Vehicle Registration	29,992,000	26,856,000	-3,136,000	-10.46%
Motor Vehicle Title	950,000	979,000	29,000	3.05%
Mixed Drink	4,849,000	4,576,000	-273,000	-5.63%
Business	1,659,000	1,194,000	-465,000	-28.03%
Privilege	25,702,000	20,997,000	-4,705,000	-18.31%
Gross Receipts	106,000	63,000	-43,000	-40.57%
TVA - In Lieu of Tax Payments	21,114,000	22,012,000	898,000	4.25%
Alcoholic Beverage	3,666,000	3,567,000	-99,000	-2.70%
Sales and Use	601,482,000	576,927,000	-24,555,000	-4.08%
Motor Vehicle Fuel	18,218,000	17,750,000	-468,000	-2.57%
Severance	144,000	154,000	10,000	6.94%
Coin-operated Amusement	3,000	0	-3,000	-100.00%
Unauthorized Substance	79,000	99,000	20,000	25.32%
Total	$1,399,584,000	$1,391,940,000	($7,644,000)	-0.55%

Table 2
Tennessee Department of Revenue
Comparative Statement of Collected Revenues

	August - April			
Class of Tax	2006-2007	2007-2008	Change	Percent
Franchise & Excise	$1,355,147,000	$1,272,371,000	-$82,776,000	-6.11%
Income	236,719,000	277,410,000	40,691,000	17.19%
Inheritance & Estate	79,597,000	83,278,000	3,681,000	4.62%
Gasoline	453,096,000	460,486,000	7,390,000	1.63%
Petroleum Special	48,544,000	48,795,000	251,000	0.52%
Tobacco	103,397,000	205,311,000	101,914,000	98.57%
Beer	13,511,000	13,840,000	329,000	2.44%
Motor Vehicle Registration	191,828,000	186,464,000	-5,364,000	-2.80%
Motor Vehicle Title	8,254,000	7,935,000	-319,000	-3.86%
Mixed Drink	39,624,000	40,671,000	1,047,000	2.64%
Business	14,362,000	14,947,000	585,000	4.07%
Privilege	215,522,000	192,480,000	-23,042,000	-10.69%
Gross Receipts	14,550,000	14,056,000	-494,000	-3.40%
TVA - In Lieu of Tax Payments	184,134,000	204,297,000	20,163,000	10.95%
Alcoholic Beverage	30,784,000	32,114,000	1,330,000	4.32%
Sales and Use	5,072,888,000	5,129,344,000	56,456,000	1.11%
Motor Vehicle Fuel	137,862,000	135,221,000	-2,641,000	-1.92%
Severance	1,177,000	1,683,000	506,000	42.99%
Coin-operated Amusement	91,000	66,000	-25,000	-27.47%
Unauthorized Substance	1,322,000	1,506,000	184,000	13.92%
Total	$8,202,409,000	$8,322,275,000	$119,866,000	1.46%

Table 3
August - April Revenue Overcollections/(Undercollections)
Budgeted Estimate

	General Fund	Other Funds	Total
Sales Tax	$ (159,700,000)	$ (7,800,000)	$ (167,500,000)
Income Tax	19,000,000	9,600,000	28,600,000
Inheritance Tax	6,600,000	0	6,600,000
Privilege Tax	(40,600,000)	200,000	(40,400,000)
Business Tax	200,000	0	200,000
TVA	5,100,000	3,800,000	8,900,000
Gross Receipts	(1,000,000)	0	(1,000,000)
Gasoline & Motor Fuel Taxes	300,000	8,000,000	8,300,000
Motor Vehicle Registration	(100,000)	(2,200,000)	(2,300,000)
Other Taxes	(61,600,000)	100,000	(61,500,000)
Sub-Total	**$ (231,800,000)**	**$ 11,700,000**	**$ (220,100,000)**
F & E Taxes	(136,800,000)	0	(136,800,000)
Total	**$ (368,600,000)**	**$ 11,700,000**	**$ (356,900,000)**

STATE BUDGET UPDATE: APRIL 2008

With a few exceptions, state finances are deteriorating, in some cases considerably. This development has presented many state lawmakers with a twofold problem: keeping their fiscal year (FY) 2008 budgets in the black and enacting balanced budgets for FY 2009.

Current state fiscal conditions are being driven by weak revenue performance. State officials expected revenue growth to slow in FY 2008, but not as dramatically as it has. Since the November 2007 edition of this report, revenue problems have grown and budget holes have deepened. Whether or not the national economy is in recession—a subject of ongoing debate—is almost beside the point for some states because their fiscal situations have declined so much that they appear to be in a recession.

Because most FY 2008 budgets were built on revenue forecasts that are not materializing as expected, budget gaps have grown. In November, seven states and Puerto Rico reported shortfalls. That number rose to 16 states and Puerto Rico by mid April. Collectively, these gaps totaled at least $11.7 billion.

The situation is worse for FY 2009: Budget gaps have emerged in 23 states and Puerto Rico, and collectively they exceed $26 billion. Again, slowing or declining revenue is the principal reason. In fact, two-thirds of the states are *concerned* about FY 2009 revenue performance. Four states are *pessimistic*.

But the news is not bad everywhere. So far, some states have avoided fiscal problems because of special economic circumstances or economies based on energy-related revenues. But if the national economy continues to struggle and indeed falls into recession, the state fiscal situation will worsen. Even states with stable fiscal situations could be vulnerable to budget stress. And states already facing problems likely would confront more severe ones.

This report provides information on all 50 states and Puerto Rico. It is based on information collected from legislative fiscal directors in April 2008. It covers the revenue and expenditure situation for the first three quarters of FY 2008 for most states. It includes information on revenue performance, spending overruns, projections of budget gaps in FY 2008 and FY 2009, the revenue outlook for next year and the overall fiscal situation in each state.

FY 2008 Revenue Performance

"Revenue is the problem," as one legislative fiscal director so succinctly noted. Indeed, anemic revenue performance has caused the vast majority of current state fiscal problems. Not every state has experienced revenue problems, however. In fact, revenues are performing exceptionally well in energy producing states like Alaska and Wyoming. But for those states that do not benefit from severance taxes, the revenue situation has been more volatile.

State budgets are not static and officials constantly are monitoring revenue collections and spending levels. Because of revenue concerns, many states have reduced their current-year revenue forecasts, in some cases several times. This section reviews state revenue performance relative to the latest estimates.[1] The greatest concern is where collections are failing to meet forecasts that already have been lowered.

Personal Income Taxes

Personal income taxes account for just over one-third of state own-source revenues. Nine states do not levy a broad-based personal income tax.[2]

- Twenty states reported that personal income tax collections were on target with the latest forecast. In 10 of these, however, the forecast had been reduced. In five states, collections were on target with a higher forecast.
- Collections were above target in 11 states. Two states had upped the forecast and three had lowered it.
- Twelve states indicated that personal income tax collections were failing to meet the forecast, and in eight of these, collections were even below a reduced forecast.

General Sales Taxes

Like the personal income tax, general sales and use taxes represent about one-third of state collections. Five states do not levy a state-level sales tax: Alaska, Delaware, Montana, New Hampshire and Oregon.

- Sales tax collections were on target in 22 states. In 13 of these states, however, the forecast had been lowered. Collections were on target with higher forecasts in four states.
- Sales tax collections were above forecast in eight states. Five states had not updated the forecast, two had lowered it and one had increased it.
- Collections fell below forecast in 16 states. In nine of these, collections were failing to meet a reduced forecast.

1. States provided performance data through February or March, the latest month for which revenue information was available.
2. Nine states do not levy a broad-based personal income tax: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming. Tennessee, which taxes dividends and capital gains, is included in this section of the report. New Hampshire has a tax similar to Tennessee's but did not provide information.

Corporate Income Taxes

On average, corporate taxes account for about 7 percent of state tax collections, but a couple of states depend on them for more than 20 percent of their collections. Four states do not levy a corporate income tax: Nevada, South Dakota, Texas and Wyoming.

- Corporate income tax collections were on target in 20 states, although the targets had been lowered in 13 of these.
- Eleven states reported that collections were above forecast. In three of these they were above a reduced forecast and in five they were exceeding a higher forecast.
- In 16 states, corporate income tax collections were below expectations. Collections in seven states failed to meet even the lower forecast.

Other Taxes

States rely on a variety of miscellaneous tax sources for income. These include taxes on oil and gas, real estate transfers, cigarettes, meals and rooms, insurance premiums, motor fuel, estate and various others. Table 4 contains detailed information. The most obvious trend in miscellaneous taxes pertained to mineral and severance tax collections. Nine states reported that oil, gas or other mineral-related levies were above forecasted levels.

Spending Overruns in FY 2008

With revenue growth slowing, it is fortunate that state spending plans largely have remained stable. About a quarter of the states and Puerto Rico reported spending overruns in November. Since that time, eight states have been added to the list. Most overages appear to be modest.

- Through mid April, four states—Connecticut, Kansas, Minnesota and Washington—reported unbudgeted increases in education spending.
- Corrections or juvenile justice programs have exceeded budgeted levels in Connecticut, Maryland, Mississippi, Oklahoma, South Carolina and Virginia.
- In November, Medicaid was exceeding budgeted levels in Arizona and New Mexico. Maryland had expected a Medicaid shortfall, but it did not materialize. By April, Medicaid or other health care spending was over budget in seven additional states: Colorado, Hawaii, Iowa, Kansas, Mississippi, Nevada and Washington.
- Energy costs are higher than budgeted in a few states. In November, Maryland and Vermont reported cost increases for low-income energy assistance programs. Fuel and electricity costs were roughly $5 million over budget in Maine. In April, New Mexico reported that gasoline expenses for state police vehicles and school buses were over budget. In Hawaii, electricity costs for the university system were exceeding budgeted amounts.

FY 2008 Budget Gaps

As already noted, slowing revenue growth is the principal explanation of state budget problems. As anemic revenue collections have continued, the number of states reporting budget gaps has risen.

- In November, seven states and Puerto Rico reported budget gaps. That number had grown to 16 states and Puerto Rico by April.
- The cumulative shortfall for FY 2008 reached at least $11.7 billion. Many states have resolved all or most of their imbalance, so the current estimated gap is $3.2 billion.
- In three jurisdictions the budget gaps reached at least 5 percent of the general fund budget. These were: Arizona (11.3 percent), Nevada (9.4 percent) and Puerto Rico (7.9 percent).
- More than half the 16 states have cut spending to eliminate all or portions of the shortfall. Florida implemented $1 billion in cuts during a special session last October and imposed additional reductions during the regular session in 2008. Nevada imposed across-the-board cuts for all agency budgets including K-12 education.
- Other actions have included tapping rainy day funds or other state accounts, using debt financing or reducing capital projects.

Projected FY 2009 Budget Gaps

The revenue problems that are undermining FY 2008 budgets are expected to get worse next year. At the same time, however, half the states do not anticipate a FY 2009 budget gap. Several states noted that a further deterioration in the national economy could trigger a shortfall, but that current estimates of revenues and expenditures were aligned. Some also indicated that reserves were sufficient to offset a revenue shortfall should one develop in the next fiscal year.

More states are reporting estimated gaps for FY 2009 than for FY 2008. As a result, the cumulative total is higher.

- Twenty-three states and Puerto Rico project FY 2009 budget gaps.
- The cumulative shortfall is projected to be at least $26 billion (four states were still determining the size of their gaps). Many states have closed or are in the process of closing these gaps during their 2008 legislative sessions.
- Ten states report budget gaps of 5 percent or more of their general fund budgets. In half of these the imbalance exceeds 10 percent. They are: Alabama (12.6 percent), Arizona (17.9 percent), California (11.2 percent), Florida (10.3 percent) and Nevada (16.9 percent).
- Sixteen states reported gaps for both FY 2008 and FY 2009.

During the recession earlier this decade, states turned largely to spending cuts to balance their budgets. Broad-based tax increases were rare, although some states looked to revenue enhancements such as fee increases to shore up their budgets. Actions under consideration to close FY 2009 budget gaps resemble those taken so far to close FY 2008 gaps and those taken several years ago when state fiscal conditions were particularly severe.

- At least 16 states will reduce spending to help balance their budgets. In some cases, programs will be eliminated. Although not a permanent spending reduction, a few states will defer or delay state payments. Wisconsin, for instance, is considering a school aid payment delay.
- Many states, including Alabama, Arizona, Massachusetts, Minnesota, Nevada and Wisconsin, plan to tap their rainy day funds. Nevada may use the entire balance in its rainy day fund.
- Several states, including Maine and Ohio, expect to make transfers from other state funds to the general fund. Some others plan to transfer general fund spending to other state accounts.
- States tend to shift to debt financing for capital projects when resources get tight. Nevada is among the states considering this option.
- At least eight states are pondering tax or fee increases. California is contemplating various tax-related proposals. The House and Senate in Massachusetts are considering a $1 per pack cigarette tax increase that would raise $175 million.
- Some states may sell assets. Illinois is eyeing its lottery as a possibility. Maine might sell unclaimed property.

FY 2009 Revenue Outlook

Based on actual revenue performance to date or projections about revenue growth next year, legislative fiscal directors were asked to comment on the FY 2009 revenue outlook. Overwhelmingly, they are concerned about future revenue performance.

- Thirty-three states and Puerto Rico reported a *concerned* outlook. Many indicated that uncertainties regarding the national economy are the main reason for their concern. Others are worried about consumer spending because of high food and energy costs. In Maine, for instance, officials reported that consumption based taxes are at risk if oil prices do not drop below $80 per barrel as they assumed in their forecast. In other states, flat or declining revenue growth is generating concern.
- Ten states expect revenues to be *stable* in FY 2009. These include states with energy sectors like Oklahoma, Texas and West Virginia as well as some Midwestern states like Iowa and Missouri.
- Four states—Arizona, Delaware, New York and Washington—are *pessimistic* about next year's revenue performance. Arizona, which has seen a significant fall-off in collections, is pessimistic about all revenue categories. In Delaware, officials have

repeatedly reduced their forecasts, and indicate that many categories continue to track downward. New York reports that the continued uncertainty in the financial services industry is a major concern for corporate and personal income tax collections. In Washington, the February forecast reduced expected collections by $400 million. Although Washington's reserves will cover expenditures for the remainder of the current biennium, the next biennial budget is expected to have a significant shortfall.

- Three states—Alaska, North Dakota and Wyoming—are *optimistic* about FY 2009 revenue performance. All three have energy sectors that are producing strong revenue growth. Oil revenue in Alaska is so robust that it has produced an estimated FY 2009 surplus of $8 billion, nearly double the state's single-year general fund budget.

Summary of the State Fiscal Situation

The current health of state budgets is very uneven. For energy producing states, the fiscal situation is strong and the outlook is good. But that situation is in stark contrast to states where the housing sector slump has been particularly severe or other fiscal challenges have prevailed. The following summarizes some of the comments or perspectives legislative fiscal directors provided to describe their state's fiscal situation.

On the negative side of the story:

- The state's budget outlook is bleak (California). The outlook is grim (Delaware). The state is in the midst of a three-year decline in state revenues, an unprecedented event in the last 40 years (Florida). The state faces a significant gap (Massachusetts).

From a more optimistic perspective:

- Storm recovery spending is slowing but still ongoing, and the oil and gas sector is strong (Louisiana). Revenues are exceeding legislative estimates by 13 percent (North Dakota). The state is in a strong position to withstand a stagnant economy (Idaho). With natural gas, oil and coal prices ahead of projected levels, it is possible that officials will revise FY 2009-2010 revenues upward this fall (Wyoming).

Most other states are somewhere in between these two extremes, with the majority concerned about mounting budget pressures, a deteriorating national economy and the increased problems generated by a possible recession. Ultimately, most states are worried about future revenue performance. South Dakota's note captures the situation well:

"The state outlook is relatively stable, but officials are concerned that national trends could drag the state down."